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South Korea: Managing a Large Foreign Debt

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Summary

South Korea--with the fourth largest debt among LDCs--has come under closer scrutiny from the international financial community with the emergence of the LDC debt problem, but it is unlikely to face financing problems this year. Government austerity measures and relatively good export growth over the past three years have enabled South Korea to keep debt servicing costs manageable. Seoul has retained a good international credit rating because of bankers' confidence in the country's economic management capabilities. International bankers readily provided funds for South Korea's most recent eurodollar loan at good terms

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Over the next two or three years, the possibility of a financing crunch for South Korea will hinge critically on the willingness of international bankers to lend about $4 billion per year in new funds to Seoul and to maintain short term credit lines. If, as seems likely, the international financial community is willing to take on this additional Korean debt, Seoul will be in a good position to achieve its growth and industrialization goals. On the other hand, if the bankers do not provide these new funds--which could result from any number of different developments--Seoul would face a serious financingbind. Under such conditions, growth would slow dramatically, the possibility of political unrest would increase, with Seoul of course looking to the United States for assistance.

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This memorandum was prepared by *Korea Branch, Northeast Asia Division, Office of East Asian Analysis. Comments and queries are welcome and may be directed to Chief, Korea Branch*

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Accumulating a Large Foreign Debt

South Korea's foreign debt amounted to $37.2 billion at the end of 1982, up from less than $4 billion a decade earlier. As a ratio of GNP, the debt rose from 35 percent in 1972 to 56 percent in 1982. Among developing countries, South Korea's debt is the fourth largest--behind Brazil, Mexico, and Argentina.

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Much of the growth in South Korean indebtedness can be traced to the government's decision in the 1970s to use foreign borrowings to speed economic development. Even with a strong increase in domestic savings, Korean officials realized the need for foreign capital to help finance economic growth and industrialization. Most studies of Korean development identify foreign capital inflows as an important factor contributing to the country's rapid economic growth in the 1970s. 25X1

South Korean debt also accumulated in response to the increases in oil prices over the past decade. Dependent on imported oil for more than 60 percent of its energy needs, Seoul was forced to borrow heavily from abroad to pay higher oil bills in 1974-75 and again in 1979-81. 25X1

Keeping the Payments Burden Manageable

In contrast to many of the other large LDC borrowers, South Korea has maintained a manageable financing burden. South Korea's debt service ratio was 15.5 percent last year compared with about 80 percent for Brazil and 63 percent for Mexico.* Including interest payments on short-term debt, South Korea's debt service ratio was 21 percent last year. 25X1

Relatively strong export growth and a prudent government austerity program in effect since mid-1979 are largely responsible for keeping the financing burden in line. Despite the global recession, export volume increased 40 percent during 1980-82. The expansion in foreign sales reflected South Korean progress at diversifying its export base. A doubling in ship exports last year, for example, bolstered foreign exchange earnings at a time when sales of textiles, electronics, and other

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* The debt service ratio measures the burden on the economy of foreign debt repayment; it is defined as medium and long-term repayments as a share of exports of goods and services. 25X1

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consumer goods declined. South Korean exporters have proven adept at finding new markets for their products--China and Libya in recent years are cases in point--to make up for slack demand in developed countries. 25X1

Seoul's austerity program also contributed to keeping debt servicing costs manageable by damping import demand and improving export competitiveness. By the late 1970s, South Korean economic planners had realized that the economy had overheated, structural inbalances had developed, and austerity was needed. During the past three years, Seoul has generally maintained tight fiscal and monetary policies; the growth in government spending, the money stock, and wages have all slowed dramatically. The Chun government was willing to accept slow growth -- real GNP grew by only 1.7 percent per year during 1980-82 -- and declining real wages to pave the way for sounder long-term growth. The strategy has paid off in reducing Korean inflation from 30 percent to less than 5 percent, cutting the current account deficit in half, and restoring rapid economic growth -- real GNP advanced 9 percent in first quarter 1983. 25X1

Near Term Prospects

Loans South Korea has already arranged, funds in the pipeline, and the country's good credit rating should enable Seoul to meet its 1983 foreign financing needs of $6.3 billion. The current account deficit should narrow to about $2.3 billion this year. Exports, after a sluggish start, have strengthened in recent months and should pick up further in the second half of the year as the US recovery gains momentum and global demand improves. The won, which had been overvalued, depreciated 6.5 percent during the period November 1982-March 1983 on a trade-weighted, price-adjusted basis, restoring Korean export competitiveness. Nonoil imports, which have grown rapidly because of strong domestic demand, will remain high, but overall import growth will be moderated by lower oil prices. The services deficit will remain near last year's level as lower interest rates offset the reduction in revenues from overseas construction work. 25X1

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Nonetheless, South Korea is still able to tap international capital markets fairly easily as demonstrated by the recent success of a $300 million eurodollar loan for the Korean Export-Import Bank. The success in obtaining this loan supports the view of Korean officials and the US Embassy in Seoul that South Korea will be able to obtain the foreign capital it needs as long as it pays interest rates that reflect market conditions. A $500 million loan earlier this year for the Korea Exchange Bank ran into substantial resistance because the Koreans insisted on a narrow interest rate spread. For the Ex-Im Bank loan, Seoul paid 25X1 a higher interest premium and found banks willing to participate in the loan. 25X1

Prospects Beyond 1983

The global LDC debt problem has prompted the Chun government to alter its economic policies for 1984-86 in order to reduce its foreign financing needs. Seoul has lowered its projection for the size of the debt to $49 billion for 1986--$15 billion less than earlier projections. Government authorities now hope to achieve a current account balance by 1985, rather than the $3.8 billion deficit originally forecast. Increased priority has been focused on expanding exports and several industrial projects have been delayed or canceled to slow imports and cut foreign capital needs. Planned completion dates for nuclear power plants, subways, and railroad lines, for example, have been pushed back. 25X1

Alternative Scenarios

In our judgment, two very different scenarios are possible for South Korea over the next two or three years. The more likely is that international bankers will provide the roughly $4 billion per year in new funds that South Korea will seek and that they will continue to maintain short-term credit lines. Currently, Seoul is one of the few LDCs that bankers are willing to provide new money to, largely because of their confidence in

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25X1 the country's long-term economic health and Seoul's ability to finance additional debt. Under this scenario, bankers retain their confidence in Korea, and Seoul is able to attract the funds it needs to achieve its growth and industrialization goals. 25X1

A less likely, but realistic possibility, is that the banking community will not provide Seoul with the long-term funds that South Korea seeks or they will refuse to roll over short-term credits. The LDC debt crisis has caused many bankers to retreat from foreign lending and almost all bankers are skittish about Third World borrowers. The atmosphere for lending to LDCs with large debts is especially poor, and Seoul could quickly find itself unable to get short term credits. Such a development could be sparked by:

- -- A significant shortfall in Korean exports, which could result if South Korea's rapid push into skill-intense industries fails.
- -- A debt crisis in the Philippines, which could lead bankers to shy away from other Asian countries such as South Korea and Indonesia.
- -- Political instability, which is always a possibility although Chun appears firmly in control now.

An inability of South Korea to attract sufficient foreign capital would force Seoul to make rapid adjustments in economic policy, which would have an extremely adverse impact on the outward-oriented Korean economy. Seoul would be forced initially to draw down foreign exchange reserves; such reserves currently amount to about $7 billion, equal to slightly less than three months imports. After drawing down its reserves, Seoul would have to curtail imports substantially. Because a large share of its foreign purchases are necessary raw material inputs for its export products (20 percent) and capital equipment (26 percent), cutting imports would be difficult. Unlike many other LDCs, Seoul has little leeway to cut imports without immediately and substantially reducing economic growth. Only 6 percent of Korea's foreign purchases are consumer goods. Because the labor force is growing rapidly--3 percent per year--unemployment would certainly increase. Inflation would also accelerate as higher cost domestic products were substituted for imports. 25X1

Under such difficult economic conditions, the possibility of political unrest would increase; the South Korean people are less tolerant of restraints on political freedoms when the economy is not doing well. In 1979, for example, the recession and rise in unemployment coincided with riots in Pusan and Masan. Seoul would almost certainly look to Washington for official assistance in dealing with a financing crunch and would probably point to US security interests in asking for help. 25X1

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South Korea: Composition of Foreign Debt, Year End 1982 [1]
(Million US $)

Long Term Debt (maturity more than 3 yrs)	22,609
Public loans	9,440
Commercial loans	6,195
Bank loans	5,352
Bond issue	362
IMF credit	1,259
Medium-term debt (maturity, 1 to 3 yrs)	488
Short-term debt (maturity, less than 1 yr)	14,215
Trade credit	3,339
Borrowing for oil imports	447
Refinance	5,038
Deposits	245
Other	1,238
Foreign bank branches interoffice accounts	3,908
TOTAL	37,312

1 IMF data

This Table is Unclassified.

South Korea: Major Economic Indicators

	Real GNP Growth	Export Volume Growth
1978	11.6	14
1979	6.4	-1
1980	-6.2	11
1981	6.4	18
1982	5.4	7
1983[1]	7.5	10

	Consumer Price Inflation	Nominal Wage Growth
1978	14.5	35.1
1979	18.3	28.3
1980	28.7	23.4
1981	21.3	20.7
1982	7.3	15.8
1983[1]	4.0	12.0

	Money Supply Growth	Growth in Government Spending
1978	39.3	29.2
1979	26.8	42.8
1980	25.8	28.4
1981	27.4	21.9
1982	28.1	17.8
1983[1]	15.0	12.9

1 Projection

This Table is Unclassified.

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South Korea: Balance of Payments

(Million US $)

	1978	1979	1980	1981	1982	1983[a]
Trade Balance	-1781	-4395	-4384	-3628	-2400	-2300
Exports (F.O.B.)	12711	14704	17214	20671	20961	23000
Imports (F.O.B)	14491	19100	21598	24299	23361	25300
Service Balance	224	-195	-1386	-1518	-619	-500
Receipts	4450	4826	5363	6598	7449	8000
Payments	4226	5021	6749	8116	8068	8500
Net Transfers	472	439	449	501	473	500
Current Account	-1085	-4152	-5321	-4645	-2546	-2300
Net Long Term Capital	2166	2663	1856	2842	1352	1200
Net Short Term Capital	-1171	844	1945	-82	-98	100
Errors and Omissions	-312	-329	-369	-411	-1441	-700
Overall Balance	-402	-974	-1889	-2296	-2733	-1700
Foreign Exchange Reserves	4937	5708	6571	6891	6980	7300

[a] estimated

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South Korea: Debt Service

(Billion US $)

	1979	1980	1981	1982	1983[a]	1984[b]
Principal repayment	1.6	1.5	2.0	2.1	2.5	3.0
Interest payments	1.4	2.6	3.7	3.8	3.6	4.1
- on short term debt	.4	1.2	1.9	1.5	1.5	1.4
- on medium-and long term debt	1.0	1.4	1.8	2.3	2.1	2.7
Total	3.0	4.1	5.7	5.9	6.1	7.1
Debt service to exports of goods and services ratio	15.2	18.4	20.7	20.9	19.5	20.0

a estimated

b projected

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